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BEFORE THE ARIZONA CORPORATION COMMISSION

IN THE MATTER OF THE APPLICATION
OF LAGO DEL ORO WATER COMPANY,
AN ARIZONA CORPORATION, FOR A
DETERMINATION OF THE FAIR VALUE
OF ITS UTILITY PLANTS AND
PROPERTY AND FOR INCREASES IN
ITS WATER RATES AND CHARGES FOR
UTILITY SERVICE BASED THEREON.

DOCKET NO: W-01944A-13-0215

ORIGINAL

REPLY BRIEF

May 19, 2014

Arizona Corporation Commission

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TABLE OF ABBREVIATIONS AND CONVENTIONS

Lago Del Oro Water Company (“LDO” or “Company”) uses the following abbreviations in citing to the pre-filed testimony in this brief. Other documents that were admitted as exhibits during the hearing are cited by hearing exhibit number. The final schedules setting forth the Company’s final position will be cited in abbreviated format as “Company Final Schedule XXX.” Other citations to testimony and documents are provided in full, including (where applicable) the Commission’s docket number and filing date.

LDO DEL ORO WATER COMPANY PRE-FILED TESTIMONY

| Pre-Filed Testimony | Hearing Exhibit | Abbreviation |
|--|------------------------|---------------------|
| Direct Testimony of Ray Jones | A-1 | Jones Dt. |
| Rebuttal Testimony of Ray Jones | A-2 | Jones Rb. |
| Rejoinder Testimony of Ray Jones | A-3 | Jones Rj. |
| Direct Testimony of Steven Soriano | A-4 | Soriano Dt. |
| Direct Testimony of Thomas J. Bourassa – Rate Base | A-5 | Bourassa Dt. |
| Direct Testimony of Thomas J. Bourassa – Cost of Capital | A-6 | Bourassa COC Dt. |
| Rebuttal Testimony of Thomas J. Bourassa – Rate Base | A-7 | Bourassa Rb. |
| Rebuttal Testimony of Thomas J. Bourassa – Cost of Capital | A-8 | Bourassa COC Rb. |
| Rejoinder Testimony of Thomas J. Bourassa – Rate Base | A-9 | Bourassa Rj. |
| Rejoinder Testimony of Thomas J. Bourassa – Cost of Capital | A-10 | Bourassa COC Rj. |

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STAFF PRE-FILED TESTIMONY

| Pre-Filed Testimony | Hearing Exhibit | Abbreviation |
|---|------------------------|---------------------|
| Direct Testimony of Mary Rimback | S-1A | Rimback Dt. |
| Direct Testimony of Michael Thompson | S-1B | Thompson Dt. |
| Direct Testimony of John Cassidy | S-1C | Cassidy Dt. |
| Direct Testimony of Mary Rimback – Rate Design | S-2A | Rimback RD Dt. |
| Direct Testimony of Michael Thompson – Cost of Service | S-2B | Thompson COC Dt. |
| Surrebuttal Testimony of Mary Rimback | S-3A | Rimback Sb. |
| Surrebuttal Testimony of John Cassidy | S-3B | Cassidy Sb. |
| Surrebuttal Testimony of Michael Thompson | S-3C | Thompson Sb. |

OTHER PORTIONS OF THE RECORD

| Document | Hearing Exhibit | Abbreviation |
|------------------------------|------------------------|---------------------|
| Revised Surrebuttal Schedule | S-4 | |
| Permit for Well No. 19 | A-11 | |
| Compliance Status Report | A-12 | |
| Transcript | | Tr. |

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1 Lago Del Oro Water Company ("LDO" or "Company") hereby submits its
2 Reply Brief in support of its request for a determination of the fair value of its utility plant
3 and property and for the establishment of rates and charges for water utility service based
4 thereon.¹

5 **I. REPLY TO STAFF**

6 There are essentially three issues still in dispute. First is Staff's introduction of the
7 vintage group method and several related adjustments and recommendations. Second,
8 Staff has failed to recognize the impact of bonus depreciation in the calculation of ADITs.
9 Third, Staff's BMP recommendation is disputed. All other issues, including all other
10 components of the revenue requirement and rate design, are undisputed.²

11 **A. Vintage Group Depreciation – This is Not the Time or Case for**
12 **Changing the Most Commonly Used Methodology in Arizona.**

13 The broad group method is the depreciation method "generally used by utilities in
14 Arizona."³ Deloitte & Touche states:

15 The group concept has been an integral part of utility
16 depreciation accounting practice for many years. Though the
17 concept is applicable to non-regulated entities, it is not often
18 applied. Non-regulated entities tend to depreciate individual
19 property units independently. Under the group concept, no
20 attempt is made to keep track of the depreciation reserve
21 applicable to individual items of property. This does not
22 imply loss of control, but rather is a practical approach for
23 utilities because they possess millions of items of property...

21 ¹ In this reply brief, LDO uses the same citation format, abbreviations and conventions as
22 utilized in its Initial Closing Brief dated May 5, 2014. Additionally, the parties' initial
23 briefs will be identified as "Company Br." and "Staff Br.," respectively.

24 ² Staff correctly notes in its brief that, subsequent to the hearing, Staff and the Company
25 agreed on an annual audit expense of \$7100, a return on equity of 9.7 percent, and that the
26 Company is now in full compliance and there is no reason to hold rate increases in
27 abeyance. Staff Br. at 10:19-20, 11:6-8, 12:5-7.

28 ³ Tr. at 178:12-15 (Rimback); *see also* Direct Testimony of Alexander Ibhade Igwe, CPA
29 (filed Feb. 27, 2009 in Docket No. W-02069A-08-0406) at 10:23-24 (the "group method
30 is generally accepted for ratemaking in Arizona").

1 Some regulators suggest that the reserve be recorded by
2 vintage when equal life group rates are used. These
3 suggestions are the result of confusion caused by the use of
4 the "group" in both the utility accounting concept and in the
5 name given to rate calculation procedures. Under the group
6 concept, mortality characteristics apply to the total group, not
7 to the specific components of the group. Therefore
8 suggestions for recording the reserve by vintage are
9 inconsistent with the group concept. *This recording would be
10 precise, but not accurate. (emphasis added)*⁴

11 Reading Staff's brief in this case, one could easily conclude that Staff has declared war on
12 the broad group method of depreciation and this case appears to be the site of its latest battle.
13 But Staff's attack on the broad group method should be repelled in this case.⁵

14 First, Staff has not corrected, and in fact simply ignores, that its use of the vintage
15 group method in this case has resulted in stranded plant balances.⁶ The stranded balances
16 will lead to confusion in the future, at best, and possibly increased rate base, issues the
17 Company will likely have to deal with in its next rate case. If Staff wants to declare war
18 on a tried and true methodology like the broad group method, it must be required to
19 ensure that its alternative does not lead to seriously flawed results.

20 Second, Staff should make clear the extent of its recommendation *before* closing
21 briefs so that the Company and the ALJ are not misled. As Mr. Bourassa testified in
22 rebuttal, Staff's direct filing contained no specific recommendation regarding the ongoing
23 use of the vintage group methodology.⁷ The Company was concerned.⁸ The broad group
24

21 ⁴ Bourassa Rb. at 11:1-11 *citing* Deloitte & Touche LLP, et al. *Accounting for Public
22 Utilities*. Lexis-Nexis (Matthew Bender & Co.) 2009, Sec. 6.04.

23 ⁵ Rejecting Staff's position means rejecting its accumulated depreciation and CIAC, as
24 well as Staff's depreciation expense, all of which are flawed due to its use of the vintage
group depreciation methodology. The revenue requirement actual impacts are discussed
in the Company's closing brief at 4-6.

⁶ Company Br. at 5:8-19.

⁷ Bourassa Rb. at 12:11-14.

⁸ Bourassa Rb. at 12:21 – 13:14.

1 method is the most efficient methodology to implement. Additionally, LDO is one of
2 several public service corporations affiliated with Robson Communities, Inc. and under
3 common control and management, all of which utilities use the broad group method.⁹
4 The Company was concerned that Staff was recommending a change that would result in
5 two different methodologies having to be implemented across one group of utilities.

6 Staff made no effort to clarify its recommendations in its surrebuttal filing.
7 However, the Company was relieved when Ms. Rimback testified in the hearing in
8 response to a question by her counsel that Staff was *not* recommending that the Company
9 be required to use the vintage group method going forward.¹⁰ Given this testimony,
10 it would be unreasonable, as well as contrary to general notions of due process, to allow
11 Staff to change its recommendation in its closing brief as it appears to have done. In fact,
12 it is inappropriate to allow Staff to attack the commonly used broad group method on
13 some sort of random, case-by-case basis as appears to be the case here.¹¹

14 Staff has certainly expressed some significant concerns with the use of the broad
15 group depreciation methodology.¹² The Commission may share some of these concerns.¹³

16 ⁹ Notably, Staff said nothing about the use of the broad group method in the recently
17 decided rate case for Pima Utility Company. *See* Decision No. 73573 (Nov. 21, 2012).

18 ¹⁰ Tr. at 190:4-22.

19 ¹¹ Staff never really states its recommendation in clear terms, adding to the confusion it
20 has caused in this case on this issue. However, it is hard to interpret Staff's arguments
21 attacking the group method and venerating the vintage group method as anything less than
22 a request that the Company be required to use the vintage group depreciation
23 methodology going forward. *See* Staff Br. at 5-7.

24 ¹² *See id.*

25 ¹³ Staff relies on Decision No. 74294 (January 29, 2014) to support its position. Staff Br.
26 at 6:21 – 7:13. This is the first time Staff has raised this decision, which appears to be the
only time the Commission has joined Staff in expressing concern over the use of the broad
group method. However, the circumstances appear to be different in that (New River
Utility Company) case. For starters, Staff actually, expressly and clearly, recommended a
change in depreciation methodology, at least in part it would appear, to address something
New River Utility Company had done in error. *Id.* There is also no mention of stranded
plant balances in that case, a problem Staff has created but not addressed in this one.
These differences should prevent any sort of blanket use of the *New River Utility* decision
as governing precedent for this issue in this rate case. In fact, it supports LDO's assertion

1 But the broad group method is not only a recognized method that complies with NARUC,
2 as stated, it also is the methodology most used by regulated utilities in Arizona.
3 This means there are literally hundreds of utility rates approved by the Commission that
4 were developed using broad group methodologies. In this light, if Staff now truly has
5 concerns with the continued use of the broad group method, then workshops and/or
6 rulemaking proceedings are appropriate. This way the Commission can hear from all
7 stakeholders on the alleged impropriety of the broad group method. Only in this manner
8 can the Commission make an informed decision that takes into account all factors and all
9 utilities, not just the utilities that come in for new rates and in whose rate cases Staff
10 decides to raise the issue. It is the Commission that makes rules and sets policies, not
11 Staff, and the Commission should resist and reject Staff's effort to change policy and
12 practice on an ad hoc case-by-case basis.

13 **B. Staff's ADIT Computation is Wrong and Unfair to LDO**

14 ADITs are calculated to ensure that customers receive the benefit of or are not
15 harmed by for paying taxes in the revenue requirement prior to the time the Company
16 actually pays taxes. In simplest terms, the tax timing difference is caused by timing
17 differences in book depreciation recovered in rates as compared to tax depreciation.¹⁴

18 In this case, the Company reduced the ADIT balance by \$212,724 in its rebuttal filing
19 because the Company's position changed when it accepted Staff's adjustment regarding
20 the recently purchased plant.¹⁵ When the Company accepted Staff's adjustment, there was
21 a reduction in the net book value of the subject assets, which changed the tax basis, which
22 impacted the ADIT calculation.¹⁶ Staff does not appear to dispute any of these facts.

23
24 that this is the wrong place and time for this issue to be properly addressed.

25 ¹⁴ See Bourassa Rj. at 9:4-7.

26 ¹⁵ Bourassa Rb. at 14:19 – 15:2.

¹⁶ Bourassa Rb. at 15:3-13.

1 Like LDO, Staff reduced the tax basis in the acquired plant.¹⁷ Unlike the Company,
2 however, Staff ignored the simultaneous impact on bonus depreciation. This failure to
3 account for the change in bonus depreciation is why Staff's ADIT balance is overstated by
4 more than \$235,000.

5 In its brief, Staff argues that no mention was made of bonus depreciation in the
6 original application.¹⁸ So what? The ADIT calculation did not come into play until the
7 tax basis changed, which did not happen until Staff filed its direct testimony several
8 months after the application was filed. Had Staff properly accounted for the change in the
9 bonus depreciation when it made its adjustment, the issue never would have been in
10 dispute. In any event, LDO could not anticipate which issues would be in dispute after
11 Staff filed its testimony.

12 That the Company took bonus depreciation in 2012 is reflected in the tax return,
13 which Staff requested and was provided.¹⁹ Moreover, Staff had the Company's work
14 papers reflecting bonus depreciation on the original \$3.9 million plant acquisition cost.²⁰
15 Since Staff is relying on the Company's work papers to support its position concerning the
16 vintage group plant recalculation,²¹ it can't say it did not know there was bonus
17 depreciation taken on this plant amount in 2012. Staff cannot have it both ways.
18 The Company took bonus depreciation on the \$3.9 million because that was what was
19 assumed would be the basis the Company could record on the books. That basis changed
20 when Staff reduced the net book value of \$2.7 million and the Company will have to
21

22 ¹⁷ Bourassa Rb. at 15:21-23 *citing* Staff's work papers.

23 ¹⁸ Staff Br. at 8:13.

24 ¹⁹ Tr. at 174:1-2 (Rimback).

25 ²⁰ Bourassa Rj. at 9:15-21.

26 ²¹ See Company work papers supporting the B-2 plant schedules, pages 3.4-3.29, provided to Staff on August 12, 2013.

1 amend its return.²²

2 It follows that Staff's argument that bonus depreciation could have been taken in
3 prior years when the plant was placed into service is a red herring. Ms. Rimback agreed
4 that the Company could not have taken bonus depreciation because it did not own the
5 plant.²³ Second, even if LDO had been the record owner of the plant for tax purposes,
6 bonus depreciation was *not* available to the Company in all of the years the plant was
7 placed into service.²⁴ No one can know what the bonus depreciation amount would have
8 actually been if LDO had owned the plant in prior years, but we know it would have been
9 less than the 50 percent bonus depreciation on the original \$3.9 million because bonus
10 depreciation wasn't available in each of the prior years — so it has to be less. Besides,
11 Staff never computed what the bonus depreciation would have been and thus must be
12 using a bonus depreciation number that is not supported by any evidence. The
13 Commission cannot give the customers the benefit of any prior year bonus depreciation
14 that “could” have been taken because rate payers never paid the income taxes through
15 their rates. Furthermore, the Company never realized any tax benefit. To recognize any
16 “look-back” bonus depreciation or to use bonus depreciation based on the original
17 \$3.9 million of plant and overstate ADIT (and lower rate base) would give ratepayers an
18 unjustified windfall simply because Staff failed to account for something and now refuses
19 to correct its oversight.

20
21 ²² Tr. at 84:11-25 (Bourassa). The maximum amount the Company could claim for bonus
22 depreciation has to be based upon the \$2.7 million, and not the original \$3.9 million, now
23 that it agrees with Staff on reduction to the plant by recognition of prior A/D. Otherwise,
24 the Company would be claiming a “bogus” bonus depreciation tax deduction. As such,
the Company will have to amend its returns to correct the bonus depreciation deduction,
but it can't do that until the Commission renders its decision. At this stage, the
\$2.7 million net book value is still just a proposal. But it does not change the fact that
bonus depreciation was taken in 2012 and Staff ignored it in its ADIT calculation.

25 ²³ Tr. at 177:17-23.

26 ²⁴ Bourassa Rj. at 9:9-12.

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